# THE RISKS ASSOCIATED WITH TRANSITORY BUT HIGH INFLATION

**Although the significant increase in inflation in most advanced economies is expected to be transitory, it is necessary to focus on the potential consequences of inflation staying temporarily high for longer. Companies that hitherto have been reluctant to raise prices might do so after all, higher inflation could weigh on spending but also cause wage demands to grow, inflation expectations could drift higher, the market sensitivity to growth and inflation surprises would increase and there could be fears about a change in the reaction function of the central bank. In the coming months, investors and central banks will scrutinise data in parallel, but the former will react more quickly should inflation stay high.**

There is a widely-shared feeling amongst central bankers, analysts and commentators that the increase of inflation in advanced economies should be transitory. However, this assessment is also subject of intense debate, witness the number of speeches and papers devoted to it.

Raphael Bostic, president and CEO of the Federal Reserve Bank of Atlanta, has even added a semantic twist to the discussion. He considers that economists use 'transitory' to describe something that is not persistent, but in doing so, the time dimension is lacking. This is an issue when talking about inflation as a central banker or a financial market investor. He advocates calling the recent increase in inflation as episodic. *"These price changes are tied specifically to the presence of the pandemic and, once the pandemic is behind us, will eventually unwind, by themselves, without necessarily threatening longer-run price stability."*[1] Although there is no reference to timing either, the insistence that price changes will unwind by themselves should be reassuring. Isabel Schnabel, executive board member of the ECB, brings a similarly reassuring message by comparing the current inflationary spike to a sneeze. *"Chances are high that the current episode of above-target inflationary pressures will subside over time."*[2] However, the IMF insists that inflation prospects are surrounded by great uncertainty, with risks being skewed to the upside.[3] Yet, even in a tail-risk scenario and provided that expectations remain well-anchored, headline inflation in advanced economies would go back to trend by early 2024 after peaking at 4.4% by mid-2022.[4]

At the risk of oversimplifying, it looks as if, whatever happens, high inflation should be transitory. This is because one-off price shocks drop out of the annual inflation numbers after twelve months, supply bottlenecks do not last and, if required, central banks will tighten policy to cool down demand. Perhaps we should focus more on the risks associated with inflation staying temporarily high for longer.

Several concerns spring to mind. One, companies that hitherto have been reluctant to raise prices might do so after all, leading to an ever larger number of goods and services with sizeable price increases. This phenomenon is, to some degree, already observable in the US (chart1), although not in the Eurozone (chart2)[5]. Such a broadening could in turn trigger more price increases throughout the value chains. Two, through its impact on company profits and households' purchasing power, this could weigh on investment and personal consumption. Three, higher inflation could fuel demand for higher wages, in particular in the presence of labour market bottlenecks. In the US, the latest CFO Survey shows *"Seventy-four percent of survey participants report that their companies are having difficulty filling open positions. Among these firms, 82 percent are increasing starting wages – by an average of 9.8 percent – in an attempt to fill these vacancies, and 33 percent are implementing or exploring automation to replace workers*."[6] Four, the longer inflation remains high, the greater the risk that it would be considered as permanent rather than transitory. This could cause a gradual unanchoring of inflation expectations, giving an extra boost to price increases and wage demands. Five, market sensitivity to inflation data would increase, even if inflation expectations would still be well-anchored. With the rate of price increases having been above target for some time, there could mounting impatience to see inflation moving below target. This increased sensitivity should lead to higher bond and equity market volatility, which in turn can weigh on the real economy. Six, market-based inflation expectations might increase, causing a jump in bond yields and, possibly, a drop in equity prices. Finally, there could be increasing concern about a sudden change in the message coming from central banks, i.e. a change in their reaction function. This would cause market turbulence with investors trying to interpret the change in the central banks' attitude towards inflation.

In the coming months, more than ever, the data will be scrutinised in order to gauge whether risks are increasing. Investors and central banks will do this in parallel, but the former will react more quickly. They anticipate the possible reaction of the central banks. Herd behaviour can play an important role in guessing the central bank's reaction. Central banks, being afraid of tightening prematurely, will need more data on many more indicators than only prices before they change their mind.

**William De Vijlder**

1. Raphael Bostic, "*The current inflation episode: have we met our FAIT?*," speech at the Peterson Institute for International Economics, Federal Reserve Bank of Atlanta, 12 October 2021.
2. "*Prospects for inflation: sneezes and breezes*", Welcome address by Isabel Schnabel, Member of the Executive Board of the ECB, at the ECB and Federal Reserve Bank of Cleveland's *"Inflation: Drivers and Dynamics Conference 2021"*, Frankfurt am Main, 7 October 2021
3. IMF, World Economic Outlook, October 2021
4. *"The exercise simulates inflation developments assuming a tail scenario which, according to the model employed here, has less than 0.01 percent probability of materializing. This scenario is marked by strong rises in commodity prices and sectoral inflation dispersion over the next 12 months."* IMF, World Economic Outlook, October 2021, chapter 2.
5. Cells are highlighted when inflation is 2% or more.
6. The survey, published on 14 October, is a collaboration of Duke University's Fuqua School of Business and the Federal Reserve Banks of Richmond and Atlanta.

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## UNITED STATES: INFLATION DISPERSION

| Item weight | All items 100.00 | All items less Food & Energy (core) 79.27 | Food 13.25 | Energy 7.48 | Energy commodities 4.20 | Energy services 3.28 | Shelter 33.49 | Household furnishings & supplies 3.31 | Transport. commodities less motor fuel 6.44 | Medical care commodities 1.69 | Recreation commodities 1.76 | Education & communication commodities 0.50 | Services less energy services 60.10 | Transportation services 5.92 | Medical care services 7.14 | Recreation services 3.88 | Education & communic. services 6.03 | Other personal services 1.64 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | year/year % change | | | | | | | | | | | | | | | | | |
| Sept. 2021 | 5.4 | 4.0 | 4.6 | 24.8 | 41.7 | 8.5 | 3.2 | 4.8 | 14.9 | -1.6 | 3.5 | 2.6 | 2.9 | 4.4 | 0.9 | 3.5 | 1.7 | 3.4 |
| Aug. 2021 | 5.3 | 4.0 | 3.7 | 25.0 | 41.9 | 8.6 | 2.8 | 3.3 | 17.2 | -2.5 | 3.3 | -0.5 | 2.7 | 4.6 | 1.0 | 3.5 | 1.3 | 3.6 |
| Jul. 2021 | 5.4 | 4.3 | 3.4 | 23.8 | 41.2 | 7.2 | 2.8 | 3.0 | 19.8 | -2.1 | 3.2 | -0.2 | 2.9 | 6.4 | 0.8 | 3.7 | 1.2 | 3.1 |
| Jun. 2021 | 5.4 | 4.5 | 2.4 | 24.5 | 44.2 | 6.3 | 2.6 | 3.4 | 20.3 | -2.2 | 3.2 | -1.2 | 3.1 | 10.4 | 1.0 | 1.9 | 2.4 | 2.5 |
| May 2021 | 5.0 | 3.8 | 2.2 | 28.5 | 54.5 | 6.2 | 2.2 | 3.7 | 13.3 | -1.9 | 3.5 | -1.4 | 2.9 | 11.2 | 1.5 | 0.6 | 2.2 | 2.8 |
| Apr. 2021 | 4.2 | 3.0 | 2.4 | 25.1 | 47.9 | 5.4 | 2.1 | 3.2 | 9.2 | -1.7 | 2.9 | -2.2 | 2.5 | 5.6 | 2.2 | 1.8 | 2.0 | 3.0 |
| Mar. 2021 | 2.6 | 1.6 | 3.5 | 13.2 | 22.0 | 4.1 | 1.7 | 2.8 | 4.5 | -2.4 | 0.8 | -4.9 | 1.6 | -1.6 | 2.7 | 1.2 | 2.0 | 2.9 |
| Feb. 2021 | 1.7 | 1.3 | 3.6 | 2.4 | 1.6 | 3.2 | 1.5 | 2.3 | 4.2 | -2.5 | 0.3 | -2.7 | 1.3 | -4.4 | 3.0 | 1.1 | 2.1 | 2.2 |
| Jan. 2021 | 1.4 | 1.4 | 3.8 | -3.6 | -8.7 | 2.1 | 1.6 | 2.4 | 4.6 | -2.3 | -0.2 | -1.9 | 1.3 | -4.1 | 2.9 | 0.3 | 2.0 | 2.0 |
| Dec. 2020 | 1.4 | 1.6 | 3.9 | -7.0 | -15.2 | 2.6 | 1.8 | 2.9 | 5.0 | -2.5 | -0.2 | -2.5 | 1.6 | -3.5 | 2.8 | 1.6 | 2.3 | 2.9 |
| Nov. 2020 | 1.2 | 1.6 | 3.7 | -9.4 | -19.3 | 2.3 | 1.9 | 2.9 | 5.1 | -1.1 | -1.0 | -4.3 | 1.7 | -3.4 | 3.2 | 2.6 | 2.4 | 2.4 |
| Oct. 2020 | 1.2 | 1.6 | 3.9 | -9.2 | -18.1 | 1.4 | 2.0 | 1.9 | 5.3 | -0.8 | -1.3 | -5.0 | 1.7 | -5.1 | 3.7 | 2.6 | 2.7 | 2.8 |

SOURCE: BLS, BNP PARIBAS

## EURO AREA: INFLATION DISPERSION

| Item weight | All-items HICP 1000 | Food & non alcoholic beverages 172.6 | Miscellaneous goods & services 99.8 | Operation of personal transport equip. 79.7 | Actual rentals for housing 74.7 | Furnishings, household equip. & routine 67.6 | Catering services 62.6 | Electricity, gas & other fuels 58.9 | Clothing & footwear 53.0 | Purchase of vehicles 39.4 | Communications 32.0 | Water supply & services for dwelling 30.6 | Tobacco 25.5 | Other recreational items & equip. 23.7 | Out-patient services 21.3 | Medical products, appliances & equip. 21.1 | Alcoholic beverages 19.5 | Recreational & cultural services 18.2 | Transport services 18.2 | Newspapers, books & stationery 14.2 | Audiovisual, photo & IT equip. 13.6 | Maintenance & repair of dwelling 13.3 | Accommodation services 12.5 | Education 10.4 | Hospital services 7.6 | Package holidays 6.2 | Other durables, recreation & culture 3.7 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | year/year % change | | | | | | | | | | | | | | | | | | | | | | | | | | |
| Aug. 2021 | 3.0 | 1.9 | 2.0 | 11.0 | 1.1 | 2.0 | 1.9 | 12.5 | 3.6 | 3.3 | 0.1 | 1.9 | 3.0 | 2.1 | -0.4 | 0.7 | 1.3 | 1.5 | 2.5 | 2.1 | 0.6 | 3.4 | 5.6 | 0.2 | 1.6 | -0.9 | -0.6 |
| Jul. 2021 | 2.2 | 1.4 | 1.9 | 10.6 | 1.1 | 1.3 | 1.8 | 11.2 | -3.3 | 3.3 | -0.1 | 1.9 | 3.0 | 1.7 | -0.4 | 0.5 | 1.2 | 1.7 | 0.3 | 2.0 | -0.6 | 3.0 | 3.0 | 0.2 | 1.6 | -4.3 | -0.7 |
| Jun. 2021 | 1.9 | 0.2 | 1.9 | 10.2 | 1.3 | 1.0 | 1.7 | 8.3 | 1.8 | 2.4 | -1.0 | 1.6 | 3.1 | 1.2 | -0.3 | 0.0 | 0.2 | 1.6 | -2.0 | 1.8 | -0.9 | 2.4 | -2.2 | 0.2 | 2.0 | -5.9 | -0.6 |
| May 2021 | 2.0 | 0.1 | 1.7 | 11.1 | 1.3 | 0.8 | 1.4 | 7.7 | 0.4 | 2.1 | -1.1 | 1.6 | 3.8 | 1.3 | -0.2 | 0.0 | 0.2 | 1.2 | -0.9 | 1.7 | -0.7 | 2.2 | -3.2 | 0.3 | 1.8 | 1.5 | 0.4 |
| Apr. 2021 | 1.6 | 0.0 | 1.7 | 9.0 | 1.3 | 0.7 | 1.5 | 6.3 | -0.2 | 1.8 | -1.1 | 1.6 | 4.4 | 1.0 | -0.7 | 0.1 | 0.6 | 1.4 | -2.6 | 1.8 | -0.2 | 2.1 | -2.9 | 0.1 | 1.8 | -3.8 | 0.5 |
| Mar. 2021 | 1.3 | 0.7 | 1.7 | 4.9 | 1.2 | 0.8 | 1.4 | 2.3 | -1.3 | 1.7 | -1.7 | 1.5 | 4.3 | 1.5 | -0.5 | 0.3 | 0.4 | 1.2 | 0.8 | 1.7 | -0.8 | 1.5 | -2.0 | 0.1 | 1.8 | -1.1 | 1.4 |
| Feb. 2021 | 0.9 | 0.8 | 1.7 | 0.0 | 1.2 | 0.8 | 1.3 | -1.0 | 0.7 | 1.3 | -1.3 | 1.5 | 5.6 | 1.6 | -0.5 | 0.3 | 0.5 | 1.2 | -0.6 | 1.8 | 0.5 | 1.4 | -1.7 | 0.1 | 1.8 | -2.7 | 1.2 |
| Jan. 2021 | 0.9 | 1.0 | 1.8 | -2.6 | 1.1 | 1.2 | 1.5 | -1.4 | 2.5 | 1.3 | -1.3 | 1.5 | 5.4 | 1.5 | -0.5 | 0.4 | 0.3 | 1.3 | -0.8 | 1.7 | 0.1 | 1.5 | -2.1 | 0.0 | 1.7 | -0.9 | 1.1 |
| Dec. 2020 | -0.3 | 0.9 | 1.3 | -4.4 | 1.2 | 0.1 | 1.6 | -4.0 | -2.2 | 0.4 | -2.5 | 0.9 | 5.4 | 0.8 | -0.2 | -0.1 | -0.3 | 1.5 | -3.3 | 1.6 | -0.8 | 1.1 | -1.8 | -0.1 | 2.3 | -3.4 | 0.4 |
| Nov. 2020 | -0.3 | 1.5 | 1.4 | -5.3 | 1.2 | 0.0 | 1.6 | -5.0 | -0.9 | 0.6 | -2.5 | 1.0 | 5.4 | 0.4 | -0.1 | -0.2 | 0.0 | 1.2 | -4.2 | 1.6 | -1.3 | 1.0 | -2.5 | -0.1 | 2.3 | -3.8 | 0.5 |
| Oct. 2020 | -0.3 | 1.7 | 1.4 | -4.9 | 1.2 | 0.1 | 1.7 | -5.5 | -0.5 | 0.6 | -3.0 | 0.9 | 6.0 | 0.9 | 0.0 | -0.3 | -0.2 | 1.4 | -5.2 | 1.9 | -1.8 | 1.0 | -4.2 | -0.1 | 2.2 | -3.9 | 0.5 |
| Sept. 2020 | -0.3 | 1.4 | 1.3 | -4.6 | 1.2 | 0.2 | 1.7 | -5.7 | -1.4 | 0.7 | -2.2 | 0.8 | 6.0 | 0.8 | 0.1 | -0.2 | 0.0 | 1.3 | -4.7 | 2.0 | -2.3 | 1.5 | -5.2 | 1.1 | 2.1 | -3.3 | 0.4 |

SOURCE: EUROSTAT, BNP PARIBAS